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ABSTRACT

To cover the costs of college, students and their families are using loans, grants, savings, and, increasingly, a specific type of college savings plan known as a "529." These planned are named after a Section of the Internal Revenue Code that confers tax exemption to qualified state tuition programs. There are two types of 529 plans: prepaid tuition plans and college savings plans. With a prepaid plan, families may purchase future tuition years or units. College savings plans allow families to establish, and contribute to, a special savings or investment account dedicated to a student's future higher education expenses at any accredited postsecondary institution. The most appealing benefit for many families is the tax saving. As of January 1, 2002, the earnings on these accounts are exempt from federal taxes, provided the money is used for educational expenses. There are some drawbacks, chief of which is the investment risk of college savings plans. The assumptions on which many prepaid tuition plans were established proved to be faulty, as tuition rates have risen faster than investment income from the plans. Several states have temporarily stopped accepting applications for these plans. In spite of these complications, however, interest and investment in Section 529 college savings plans is growing. In September 2003, a new type, the Independent 529 plan, was opened. This plan will allow families to prepay for any one of more than 220 private colleges and universities that are participating. This plan hopes to avoid the problems of others by having the participating colleges assume the risk that if tuition increases outpace investment returns, they will not receive full payment. (SLD)

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Paying for College: Prepaid Tuition and College Savings Plans
By Shannon Loane

Introduction
In 2003-2004, tuition and fees at public four-year colleges and universities averaged $4,694, while those at private four-year colleges averaged $19,710. Total charges, including room and board, were $10,636 at public institutions and $26,854 at private ones. Between 1993-94 and 2003-04, average tuition and fees rose 47% at public four-year institutions and 42% at private institutions. (College Board, Trends in College Pricing 2003, p. 3)

To cover these costs, students and their families are using loans, grants, savings, and, increasingly, a specific type of college savings plan known as a 529.

What are 529s?
Section 529 college savings plans are named after the 1996 Internal Revenue Code section that confers tax exemption to "qualified State tuition programs" (Hurley, 2002, pp. 12-13). There are two basic types of 529 programs – prepaid tuition plans and college savings plans.

With a prepaid tuition program, families may purchase future college tuition years or units, generally at that state's eligible colleges or universities (or an equal amount toward private or out-of-state tuitions), at current rates.

College savings plans allow families to establish, and contribute to, a special savings or investment account dedicated to a student's future higher education expenses at any accredited postsecondary institution. The account is similar to a mutual fund account in that the contributor chooses investments or an investment strategy, usually stocks and bonds in varying proportions depending on the age of the beneficiary and the contributor's tolerance for investment risk.

The ideas behind these plans are not new. The first prepaid tuition plan was introduced in Michigan in the late 1980s (Ma & Fore, 2002, p. 24; Hurly, 2002, p. 12). Today, each of the fifty states, and the District of Columbia, offer at least one plan (either prepaid or savings), and many offer more than one.

Initially, there were problems determining the tax status of accounts. The addition of Section 529 to the Internal Revenue Code in 1996, and changes made to that section since then, have clarified and enhanced the tax benefits of these accounts.

Benefits
The most appealing benefit, for many families, is the tax savings. As of January 1, 2002, the earnings on these accounts are exempt from federal taxes, provided the money is used for educational expenses. (This exemption will expire on December 31, 2010 unless renewed by Congress. See Ma & Fore, 2002, p. 25) Although state tax laws vary, many provide for tax deductions or exemptions of contributions and/or earnings.

Another benefit of the plans is their flexibility. Anyone can open or contribute to a 529 plan. Most savings plans do not restrict eligible individuals to their state residents, so families can compare plans from many states to find the one best suited to their needs. Withdrawals from the plans can be used for much more than just tuition – they can pay for fees, room and board, books, supplies, and equipment. Also, the plans can be transferred to another member of the initial beneficiary's family.

Complications
There are complications, however.

College savings plans have investment risk. The value of a college savings plan depends on the performance of the investment or investment package chosen by the contributor, and, as with any investments, the plan can actually decrease in value at times (Investment Company Institute, 2002, p. 5).

With prepaid tuition plans, the assumptions on which many programs were established proved to be faulty. The plan administrators assumed that the money collected from account holders and invested would rise in value more quickly than tuition rates. Lately,

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however, many colleges have been increasing tuition rates rapidly (mainly as a result of decreased state support in a weak economy), and the plans' returns on investments have decreased, and in some cases, the plans have even lost money (Investment Company Institute, 2002, p. 5). Recently, several states, including Kentucky, Texas, and West Virginia, have temporarily stopped accepting new applications for their prepaid tuition plans. Colorado has closed its plan permanently to new applications, and officials in other states are considering possible action (Schmidt, 2003).

One additional complication is the impact of the funds from these savings plans on students' eligibility for need-based financial aid. Savings plans funds are included as family assets in calculating aid eligibility, and thereby may decrease the amount of aid students can expect (Ma & Fore, 2002, p. 26).

Conclusion

Despite these complications, interest and investment in Section 529 college savings plans is growing – from just over 1 million accounts in 1999 to over 5 million, containing more than $35 billion and with an average value of $6,753 per account, in 2003 (College Board, Trends in Student Aid 2003, p. 4, p. 17).

A new prepaid tuition plan, the Independent 529 plan, was opened in September 2003. Similar to a state's prepaid tuition plan, this plan will allow families to prepay tuition at any one of the more than 220 private colleges or universities that are participating. This plan hopes to avoid the complications other prepaid tuition plans are encountering by having the participating colleges assume the risk that if tuition increases outpace investment returns, they will not receive full payment. This new model may enable this prepaid tuition plan to survive even in this era of steep tuition increases and small investment returns (Schmidt, 2003).

Related Websites

The College Savings Plan Network

This affiliate of the National Association of State Treasurers serves as a clearinghouse for information among existing college savings programs. The site includes a *Guide to Understanding 529 Plans* and a state-by-state overview.
http://www.collegesavings.org

The Internet Guide to 529 Plans

This excellent site includes basic information on 529 savings plans; descriptions, links to, and evaluations of all the state 529 plans; a college savings calculator; and information on finding a 529 consultant.
http://www.savingforcollege.com/

The Independent 529 Plan

This is the website of the Independent 529 Plan, the plan that allows families to prepay tuition at one of the more than 220 participating independent institutions.
http://www.independent529plan.com/

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